

February 20, 1997

Dear Legislator:

We have issued a letter report on the Tax Commission's administration of local sales taxes. This letter provides a brief digest of our report #94-06. Additional work, evaluating due process at the commission, is in progress and will be addressed in a subsequent report.

Local government officials feel the Tax Commission's administrative fee for collecting and distributing local sales taxes is too high. According to **Utah Code**, the fee is to "reimburse the commission for the cost to it in rendering the services," but may not exceed 2.5 percent of revenue. In fiscal year 1994, the commission charged local governments the maximum allowable fee of \$6.6 million. In response to the local governments' concerns, Senate Bill 47 of the 1994 General Session directed us to "conduct an audit of the collection services provided by the commission . . .to determine actual collection and distribution costs."

Any determination of local sales tax costs depends largely on how the cost of functions that simultaneously benefit both state and local governments are allocated. Functions such as rule making, forms processing, auditing, collections, and adjudication serve a dual state and local purpose. The costs of functions which provide a dual benefit are known as common costs and may be allocated between the state and local governments in a variety of ways. Other functions, such as identifying where sales occur and distributing revenue to local entities, result in marginal costs because they are performed only because of the local tax. Logically, local governments should pay all the Tax Commission's marginal costs. However, policy must guide who pays for common costs.

The level of the administrative fee is disputed because state and local government officials have differing views about what costs should be covered by the fee. Local governments feel they should not be allocated any of the common costs, because the state would incur those costs even if there were no local tax. However, Tax Commission practice has been to allocate half of common costs to local governments because the functions performed are essential to collecting the local tax.

Because the Tax Commission does not have a cost accounting system by tax type, sales tax costs must be estimated. Total sales tax costs for fiscal year 1994 were about \$10.25 million. About \$2.25 million were marginal costs due to the local tax. Another \$8 million were common costs that need to be divided between the state and local governments.

Legislative Policy Clarification Is Needed To Resolve Fee Dispute. The proper sales tax fee level depends on a legislative policy choice of how common costs should be allocated. In addition to the positions advanced by state and local officials, a third approach, allocating common costs according to revenue, also should be considered. The fee percentages indicated by the three policy alternatives are 0.85 percent (marginal cost only), 1.49 percent (marginal costs plus proportional common costs), or 2.35 percent (marginal costs plus half common costs) of local revenue. However, because future revenue and cost changes are not directly related, the percentages shown should not be considered permanent. If the fee percentage is reduced, the budgetary impact on the Tax Commission must be considered. Every 0.5 percent reduction in the fee percentage represents a \$1.3 million transfer from the commission to local governments.

Some Local Revenue Has Not Been Distributed. Our report addresses a second area, unrelated to the administrative fee. During our field work we discovered a problem with the distribution of local sales tax revenue. Although the vast majority of sales tax revenue due local governments is properly distributed, a computer programming problem has resulted in some amounts not being distributed. The problem has existed for at least several years and generally involves the failure to distribute a portion of taxpayers' payments on audits. Although Tax Commission staff have been aware of the distribution problem, its correction has been postponed because other issues were given priority. The undistributed amounts have remained in the state's account. Tax Commission staff are now working to remedy the problem and distribute past due amounts, that total about \$4 million dollars.

We hope this summary provides you with the information you need. If you have any questions or need additional information, please let us know. If you would like a copy of the full report, please contact our office.

Sincerely,

Wayne L. Welsh
Auditor General

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